

# Revisiting private equity investment in federal IT contractors

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Information technology (IT) and consulting businesses have continued to attract private equity attention and dollars. For IT businesses contracting with the federal government, there are additional attractions for private equity investors.

## BENEFITS OF FEDERAL BUSINESSES

For starters, federal government business is not as exposed to the vagaries of the U.S. consumer economy as pure B2B or B2C businesses. It is true that the federal sales cycles can be much longer than in the commercial sector.

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However, this cuts both ways as once a contract is awarded, it tends to be relatively long-term (up to five years in most cases) and the Federal Acquisition Regulations (FAR) procurement requirements disincentivize the government from terminating a contract for convenience, thus protecting the business from cost-undercutting, at least until a re-compete.

There are also high barriers to entry into the federal marketplace, including regulatory compliance programs and requirements to demonstrate experience.

Finally, the size and creditworthiness of the customer, coupled with the relative “stickiness” of contracts awarded, make these investments financeable by lenders knowledgeable about the sector. Given these attributes, it is little wonder that more and more private equity sponsors are expanding into the federal market space.

Many of the federal IT businesses are “small businesses.” The U.S. government has a number of programs designed to benefit small businesses. There are prime contracts set aside for various categories of small and/or disadvantaged businesses, such as minority-owned, woman-owned, HUBzone, 8(a) disadvantaged, veteran-owned, and service-disabled veteran-owned businesses.

On August 12, the U.S. Small Business Administration (SBA) released statistics in its fiscal year 2019 Small Business Procurement Scorecard, available [here](#)<sup>1</sup> and [here](#)<sup>2</sup>.

Of note, the federal government awarded \$132.9 billion dollars in federal contracts – 26.5% of the government’s total procurement spending – to small businesses last fiscal year, a significant portion through “set-aside” contracts.

Given the timing of the SBA release, it seems opportune to revisit the considerations private equity investors should contemplate as they evaluate potential investments in “small government contractors,” including those that have small business set-aside contracts.

## CONTROL INVESTMENT MAY RESULT IN LOSS OF SIZE STATUS

Private equity investors interested in investing in a small government contractor should understand that the investment will, under many circumstances, result in a loss of the target’s size status (converting the company from small to large).

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Additionally, an entity that converts from small to large will no longer be eligible for future small business set-aside contracts (including renewal options on certain contracts).

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This arises out of the doctrine of affiliation. Whether a contractor qualifies as a small business is determined by its employee count or gross receipts, depending on the contractor’s NAICS code.

The SBA requires the contractor to include in its employee count or gross receipts those of both the contractor *and its affiliates*. The SBA’s definition of “affiliate” is quite broad. It considers legally separate entities to be affiliated when one has the power to control the other, or both are subject to the control of a common third party.

It is not necessary that such power actually be exercised, only that it possess the power to control. And it is important to note

that “control” (and therefore affiliation) can exist even where less than a majority of the voting stock is acquired. SBA also considers significant negative controls (where an investor has the ability to block or prevent certain corporate actions) to constitute control for purposes of affiliation.

Minority investments can be structured to maintain small status but must be done very carefully. Generally, the level of influence permitted by the SBA to avoid a finding of control is less than what most institutional investors will accept.

Since a small government contractor that has a control investment by a private equity fund would have to include the employees or gross revenues of all the other portfolio companies controlled by the fund, this usually results in a conversion from small to large.

Finally, although control is generally thought to exist after a transaction closes, in some circumstances the so-called “present effect rule” can create control as early as a letter of intent. See our previous blog post here<sup>3</sup> for a discussion of the “present effect rule.”

### EFFECT OF LOSS OF SIZE STATUS

Upon a change in size status, a small business is required to take the following actions:

- Update its representation in sam.gov.
- Notify the relevant contracting officers of the change on contracting where it represented it was a small business in accordance with FAR 52.219-28 (Post-Award Small Business Program Representation).

The government is not required to terminate contracts that are awarded in whole or in part based on small business status (except for 8(a) contracts where no waiver is given), but, if the contract is not terminated, the funds spent on the contract after the change in status will no longer be counted toward the agencies’ small business goals.

Additionally, an entity that converts from small to large will no longer be eligible for future small business set-aside contracts (including renewal options on certain contracts).

### RECOMMENDATIONS FOR INVESTORS

Given the possibility that a private equity investment will convert a small business to a large business in connection

with an investment, the investor should evaluate the target business’s contract profile for small business contracts and assess its product or service relative to others in the industry.

The more specialized and differentiated the target business’s offerings, and with a history of competing successfully against large businesses, the less risky the loss of size status can be.

Conversely, the more commoditized its offerings are, or if it is competing primarily against other small businesses, the more risk the loss of size status will carry.

Private equity funds will necessarily have one eye on the eventual exit, and so must also evaluate the target’s ability to successfully compete in a full and open environment. Because if they can’t do that, then it’s probably not worth the initial investment.

### Notes

<sup>1</sup> <https://bit.ly/3mvOYC9>

<sup>2</sup> <https://bit.ly/35Lr5AE>

<sup>3</sup> <https://bit.ly/2G08LZD>

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